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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 97-0553 ITC
Adjusted Gross Income Tax
For Tax Period: 1991 Through 1993

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax: Michigan Single Business Tax Addback

Authority: IC 6-3-2-1(B); IC 6-3-1-3.5(B); TRINOVA CORP. V. Dept. of Treasury, 445 N.W. 2d 428 (Michigan 1989); Appeal Of Dayton Hudson, Sbe No. 94-Sbe-003 (California 1994); Ardire v. Tracy, 674 N.E. 2d 1155 (Ohio 1997); Consolidated Coal Company v. Indiana Department of Revenue, 583 N.E. 2d 1199 (Indiana 1991).

The taxpayer protests the addback of the Michigan single business tax.

II. Adjusted Gross Income Tax: Corporations

Authority: IC 6-3-1-28; IC 6-3-2-2; IC 6-3-3-2; IC 6-8.1-3-3(b); Tax Policy Directive #12; Indiana Department of Revenue v. Lavall Electric, 411 N.W. 2d 685 (1980); Associated Insurance Companies, Inc. v. Indiana Department of State Revenue, 49T10-9405-TA-00152 (Ind. Tax Ct. 1995).

The taxpayer protests the manner in which the computation of corporate income tax liability was made.

III. **Gross Income Tax: Income from Intangibles: Interest Income**

Authority: 45 IAC 1-1-49, 51

The taxpayer protests the inclusion of interest income of subsidiaries domiciled outside of Indiana in gross income.

IV. Adjusted Gross income Tax: Income From Intangibles: Interest Income

Authority: 45 IAC 3.1-1-50, 45 IAC 3.1-1-52

The taxpayer protests the inclusion of interest income of members of the unitary group domiciled outside of Indiana in adjusted gross income.

V. Tax Administration: Penalty

Authority: IC 6-8.1-6-1; IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the imposition of a negligence penalty.

STATEMENT OF FACTS

Taxpayer is a Virginia corporation, commercially domiciled in Ohio. Taxpayer is a parent corporation of approximately one hundred domestic wholly owned subsidiaries and approximately one hundred foreign subsidiaries. Taxpayer files a single return in Indiana; consolidated for gross income tax returns and combined for adjusted gross income tax. Additional facts will be provided as necessary in the discussion.

I. **Adjusted Gross Income: Michigan Single Business Tax Addback**

DISCUSSION

The Department audited the taxpayer for tax years 1990, 1991, and 1992. Pursuant to IC 6-3-1-3.5(b)(3) and 45 IAC 3.1-1-8, the Department required the taxpayer to add back the Michigan single business tax (hereafter "MSBT"). Taxpayer argues that this addback was improper because the Code and administrative regulations only require the addback of taxes based on or measured by income.

> (3) Add back deductions taken pursuant to Internal Revenue Code-Section 63 for:
>
> > (a) Taxes based on or measured by income and levied at the state level. For purposes of this subsection, the Indiana Gross Income tax is a state tax measured by income and must be added back (see Miles. v. Department of Treasury, 209 Ind. 172 (1935));

Taxpayer asserts that the MSBT is a value-added tax, assessed on goods and services on the value added by the taxpayer. Taxpayer further contends that the MSBT is a tax based on and measured by business activity.

Taxpayer cites numerous cases to support their contention, each of these cases does find that the MSBT is not a tax based on or measured by income. *See* Trinova Corp. v. Department of Treasury 445 N.W.2d 428 (Michigan 1989); Appeal of Dayton Hudson, SBE No. 94-SBE-003 (California 1994) Ardire v. Tracy, 674 N.E.2D 1155 (Ohio 1997);

Consolidated Coal Company v. Indiana Department of Revenue, 583 N.E. 2d 1199 (Indiana 1991). Taxpayer's position appears to be correct at this point. However, a closer reading of these cases reveals a narrower holding than the taxpayer has offered. For example, in Trinova, the Court noted that under a value added tax all forms of business organizations bear the same tax burden and that a business, even though it may be unprofitable in a given year, will owe some value added tax as contrasted with the corporate income tax, which is based on the philosophy of the ability to pay. In other words when the court discussed income, it meant a net income tax.

Further, the taxpayer cites Appeal of Dayton Hudson Corp., which did concern the addback of the MSBT under Cal. Rev. & Tax code Section 24345(b). In another case, the Franchise Tax Board chose to bifurcate the MSBT into deductible and nondeductible portions. The Board of Equalization (BOE) determined that because the MSBT includes "an element of return of capital" (i.e. the cost of labor), "the tax is measured by something other than gross income": and is, therefore, deductible. The BOE used the term "gross income" but it really seems to mean "net income." In fact, in denying the bifurcation of the tax it relied primarily upon the language contained in Trinova, supra, to conclude that he MSBT is not added back because although the MSBT begins the reference to the taxpayer's federal taxable income, it adds back compensation, depreciation and interest to make it a "compensation, depreciation, and income). . . ." In other words, the calculation of the tax may start with "net income" but it ends up being based on a value much different from that of "net income."

In other cases concerning the MSBT and its deductibility, the common thread in all of them is that the MSBT is not a tax measured by "net income." For example the Ohio Supreme Court decision in Ardire v. Tracy, 647 N.E.2d 1155 (Ohio 1997) held as much.

If Indiana law limited the addback of state taxes to those based on or measured by a "net" income tax, then the Department would have to agree with the taxpayer's conclusion that the MSBT is not a tax that is required to be added back under IC 6-3-1-3.5(b)(3) because this is the common meaning of "income." However, the Indiana supreme Court stated in Consolidated Coal Company v. Indiana Dept. of State Revenue, 583 N.E.2d 1199 at 1201 (Ind. 1991), the following in its interpretation of the taxes required to be added back under IC 6-31-3.5(b)(3):

> If "income" were the only word that required defining to resolve this case, the matter might be settled. The legislature has given us more, however, by using the phrase "based on or measured by income," this suggests a broader inquiry than would be appropriate if the legislature had provided for adding back, say, and "taxes on income." We think this broader analysis is much like the one we used in Miles v. Department of Treasury (1935), 209 Ind. 172, 199 N.E.2d 372. The Miles Court held that Indiana's Gross Income tax was a "Tax on income," focusing on whether Indiana's Gross Income Tax constituted a property or non-property tax, a critical distinction under Article X of the Indiana Constitution as it read in 1935. We think that whole phases, "based on or measured by income"

> seems likely to be used in the same, simple sense which defined the inquiry in Miles. Is the tax which the payor wishes to add back measured by income? Or measured by value of property held? We conclude that the add-back provisions at issue in this case are designed to describe the kind of tax to be added back permitting the addback of taxes based on income but not those such as property or excise taxes.

In other words, Indiana's gross income tax is a taxed based on income. The MSBT is a tax very close to the Indiana gross income tax. When you add back to the federal taxable income expenses such as the cost of capital and the cost of labor (the two biggest expenses a company has), you are coming very close to gross income. As the Indiana Supreme Court further said in Consolidated Coal, about the West Virginia Business and Occupation Tax, the rates are applied against "the value. . . actually proceeding from the sale of tangible property without any deduction on account of the cost of property sold or expenses of any kind." The Department believes the MSBT is also a tax, "measured by income" and therefore a proper addback under IC 6-3-1-3.5(b)(3).

FINDING

The taxpayer's protest of this issue is denied.

II. Adjusted Gross Income Tax: Corporations

DISCUSSION

The next issue protested by the taxpayer involves the methodology used to determine the overall tax liability of the unitary group. For the tax years 1990-1994, the taxpayer filed consolidated gross income tax returns. For those same years, taxpayer was granted permission to file, and filed on, a combined basis for adjusted gross income tax purposes. The Department calculated the liability at the entity level because there were a less number of entities in the consolidated gross return than in the combined adjusted gross return. The taxpayer argues that because the purposes of the consolidated filing is to treat the affiliated group as a single taxpayer for gross income tax purposes (See Indiana Dept. of Revenue v. Laval Electric, 411 N.E.2d 685 (1980): Associated Insurance Companies. Inc. v. Indiana Dept. of State Revenue, Indiana Tax Court 49T10-9405-TA-00152 (September 29, 1995)), the Department is in error in treating the gross liabilities separately for each member of the affiliated group. Further, taxpayer argues that the combined filing for adjusted gross income tax likewise treats a unitary group as a single entity.

Indiana Code section 6-3-3-2 states, "Corporations shall be entitled to a credit, not to exceed the amount of the tax imposed by IC 6-3-2, . . .equal to any tax imposed on gross income by IC 6-2.1-2 for the same taxable year." Under IC 6-3-4-14(d), an affiliated group of corporations making a consolidated return may apply the gross income tax credit of a member against the entire tax liability of the affiliated group. Therefore, under a consolidated filing for adjusted gross income tax, purposes, the gross income tax credit would not be limited by the adjusted gross income tax of any single member. Indiana courts have held that," . . . the spirit and intent of the gross income tax consolidated filing statute is to treat an affiliated group as a single taxpayer." *See* Assoc. Ins. Cos. v. Department of State Revenue, 655 N.E.2d 1271 (Ind. Tax Ct. 1995).

Combined reporting is based on the principle that a unitary business should be treated as a single taxpayer whether it is operating as one corporation with several divisions involved or as a parent corporation with several subsidiaries involved. *See* Edison California Stores v. McColgan 183 P.2d 16 (Cal. Sup. Ct. 1947).

Therefore, the taxpayer shall be treated as a single taxpayer for both gross and adjusted gross income tax.

FINDING

The taxpayer's protest of this issue is sustained.

III. Gross Income Tax: Income from Intangibles: Interest Income

DISCUSSION

The taxpayer also protest's the auditor' inclusion of income from intangibles in the gross income of the taxpayer. Specifically, taxpayer takes issue with the treatment of interest income from various members of the group. For gross income tax purposes, income from an intangible is taxable only if the income satisfies one of two test under 45 IAC 1-1-51. The first is the "business situs test:. Business situs" is defined at 45 IAC 1-1-49. The second test is that of commercial domicile. None of the members, whose included interest income is being protested, is commercially domiciled in Indiana, so the business situs test must be satisfied in order for interest income to be included as taxable gross income.

Taxpayer is protesting the inclusion of a percentage of all interest income, regardless of the source. Taxpayer is correct that only interest income derived from Indiana sources should be related to a business situs in Indiana. (The auditor used an average of the property and payroll factors multiplied by the total interest income to arrive at the adjustment) A business situs does not permit the taxability of all interest income; rather, tax can only be levied against interest income associated with that business situs. With respect to the members of the affiliated group assessed tax, not all of the interest income used to make the assessment is associated with Indiana, and is therefore not taxable for gross income tax purposes.

FINDING

The taxpayer's protest is sustained to the extent that the auditor's methodology included interest income not derived from a business situs in Indiana.

IV. <u>Adjusted Gross Income Tax</u>: Income from Intangibles: Interest Income

DISCUSSION

Taxpayer further protests the inclusion of this same amount of interest income in the numerator of the sales factor for adjusted gross return. Taxpayer correctly argues that only interest income derived from sources within Indiana can be included in the numerator. 45 IAC 3.1-1-50 & 52. to the extent that interest, not sourced to Indiana, was included in the numerator, the assessment was in error.

FINDING

The taxpayer's protest of this issue is sustained.

V. **<u>Tax Administration:</u> Penalty**

DISCUSSION

The department can impose a ten percent (10%) negligence penalty under IC 6-8.1-10-2.1. This code section states, in pertinent part, that if "the deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty.

Further, 45 IAC 15-11-2 states that "negligence on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary, reasonable taxpayer."

The taxpayer must demonstrate that its actions involved the use of reasonable care, caution, or diligence, in attempting to comply with the law in order to avoid a penalty. The taxpayer's arguments and evidence demonstrate that the taxpayer exercised reasonable care, caution or diligence in reporting income and remitting taxes.

FINDING

The taxpayer's protest of the penalty is sustained.